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STATEMENT BY
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ECONOMICS, POLICY ANALYSIS AND BUDGET
U.S. DEPARTMENT OF AGRICULTURE
BEFORE THE
COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON LIVESTOCK AND GRAINS
U.S. HOUSE OF REPRESENTATIVES
JULY 18, 1979

Mr. Chairman, I am pleased to appear before this group to discuss the concept and determination of target (established) prices. Target prices, developed after nearly half a century's evolution of domestic farm policies, now serve as the standard for the Government's income support activities for the nation's farmers.

The Federal Government first began the succession of programs directly involved with agricultural production and marketing to improve the economic welfare of farmers in 1929. Market price support measures were first used and then quotas, allotments and other measures for individual commodities were subsequently necessary to curtail output. These policies were implemented during the Great Depression. However, curtailment programs were not used during World War II when full production was encouraged through high prices and high support prices.

After World War II, supply-demand imbalances grew. Because there was no coordination between commodities, farmers restricted in producing one crop would turn to another. In addition, with the high support levels, foreign competitors under-sold the United States in world markets. As a result, the United States nearly became a supplier of last resort. Farmers produced for the programs rather than for existing market conditions.

By the early 1960's, the situation of huge surplus stocks resulting from high price supports and rigid programs had become intolerable and the first steps toward making farm programs more responsive to market conditions were then taken. Programs to supplement the price support loans with so called "price support payments" for certain commodities produced under quotas or allotments were initiated. This was the first major step towards separating market price and producer income supports.

By 1973, the movement toward fewer program restrictions and greater reliance on market signals to guide producer decisionmaking culminated with the full separation of price and income supports in the Agriculture and Consumer Protection Act.

The concept of using two levels of supports was not a new one--even in the mid-1960's. The separation of income from price supports was first proposed in 1949 by Secretary of Agriculture Charles Brannan--the so-called "Brannan Plan." Under this system, direct income transfers would have been provided to producers in addition to the price support loans.

The purpose of the target price is to protect producers from economic disaster. Target prices provide the basis for protecting producer income when the market price is seriously depressed. No payments are made if the market price is at or above the target price. If the market price goes below the target price, support payments are based on the difference times the producers normal production.

The 1973 Act initially established target prices for wheat, feed grains and cotton. The 1975 Rice Production Act extended the concept to that commodity.

The 1973 Act adopted a "cost of production" standard as the basis for annual adjustment of target prices instead of parity prices. But lack

of adequate cost data at that time led to the use of a broad-based index of prices for agricultural inputs. To provide a basis for the future, the 1973 Act directed the Secretary of Agriculture, in cooperation with the land grant colleges, commodity organizations, general farm organizations and individual farmers, to establish current national weighted average costs of production for wheat, feed grains, cotton and dairy commodities and to provide annual updates. These studies have since become the basis for the refined target price system adopted in the Food and Agriculture Act of 1977.

Target Prices and the Loan Program

As I previously mentioned, target prices are used as a means of income support, protecting farmers from economic disaster when atypically low prices occur. They act as a safety net, protecting producers from the consequence of disaster level market prices when supplies are in excess of market requirements. However, target prices are not--and never were--intended to be a guaranteed income program or to cover total costs of production including a full return to land based upon current land prices.

While the target price concept works in harmony with the system of loan levels, the two concepts serve very different roles. Loan levels, initially conceived to enhance farm incomes through commodity price supports, now serve two primary functions. Set at a level to keep U.S. farm products competitive in world markets, the loans:

- o assist farmers by serving as an orderly marketing tool. Farmers can place commodities under loan at harvest--the time when crop prices are typically lowest--and obtain necessary cash for meeting

their current expenses. This loan can be repaid and the commodity sold later in the year when prices have strengthened.

- o serve as a market of last resort. In the event market prices are not substantially above the loan rate, the Government, through the Commodity Credit Corporation (CCC), will take the necessary grain at the loan price.

Target prices are set at levels higher than the loan levels. Their relationship to loan rates and market prices for wheat, corn and cotton are shown in Figures 1 - 3 and Table 1. The higher amount provides income protection but does not interfere with the operation of domestic or international markets.

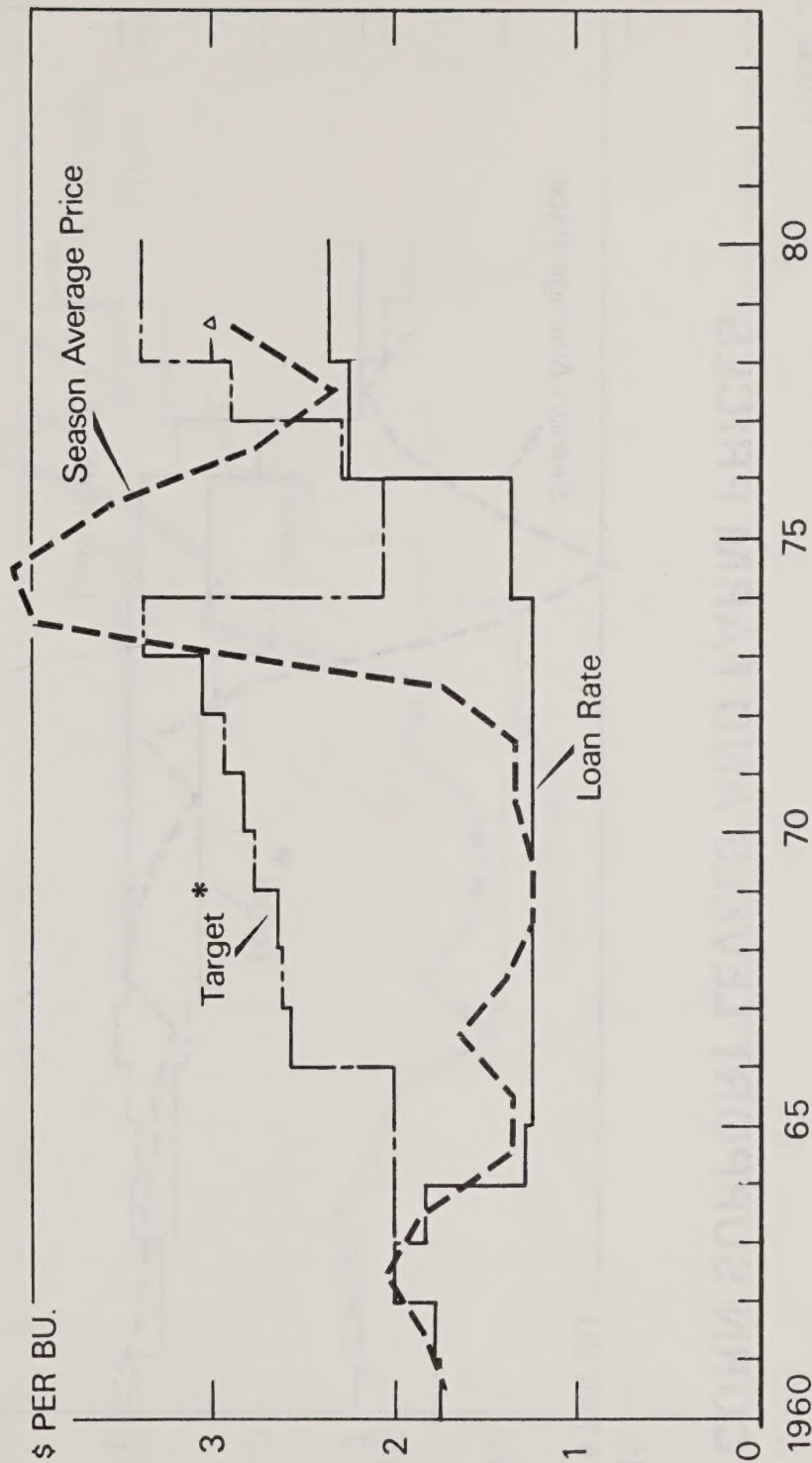
Targets Price Authorities

Under the Agriculture and Consumer Protection Act of 1973, target prices were established for wheat, feed grains and cotton for the 1974 and 1975 crop years. These levels were adjusted for the 1976 and 1977 crop years by a method which reflected changes in production costs as measured by the Department's Index of Prices Paid for Production Items, Interest, Taxes and Wage Rates and changes in the three-year moving average of individual crop yields--the latter a proxy indicator of productivity changes. (See Table 1.)

The procedure was not entirely satisfactory. The Index of Prices Paid includes several items with no relevance for crops production--(i.e., feed and feeder livestock have no bearing on the cost of producing cotton.) Furthermore, it distorted the relationship among crops since it made no allowances for varying rates of change in production costs for the various crops.

FIGURE 1

WHEAT SUPPORT LEVELS AND FARM PRICES



YEAR BEGINNING JUNE (July prior to 1976/77)

1963-73, target prices, 1974-78

Δ Estimated

FIGURE 2

CORN SUPPORT LEVELS AND FARM PRICES

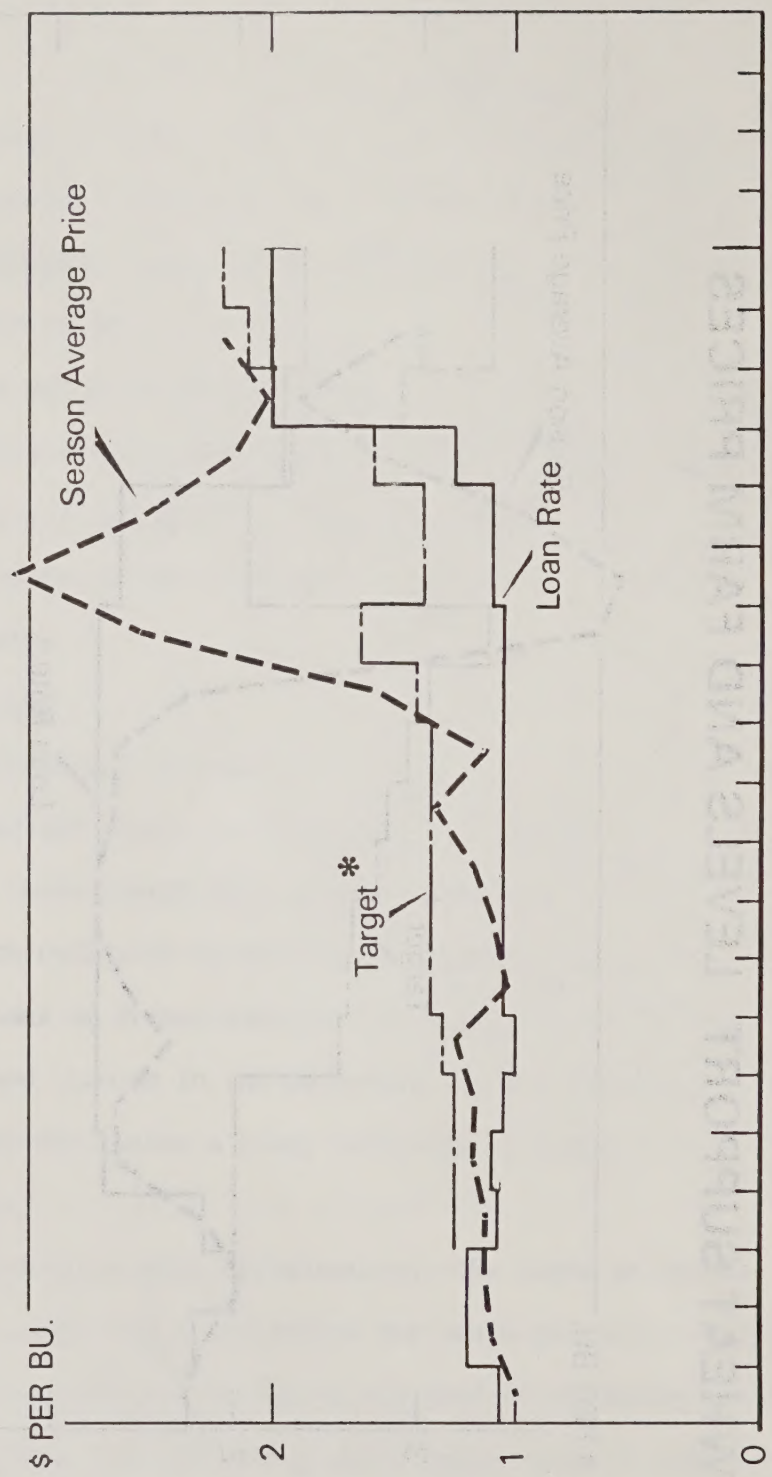
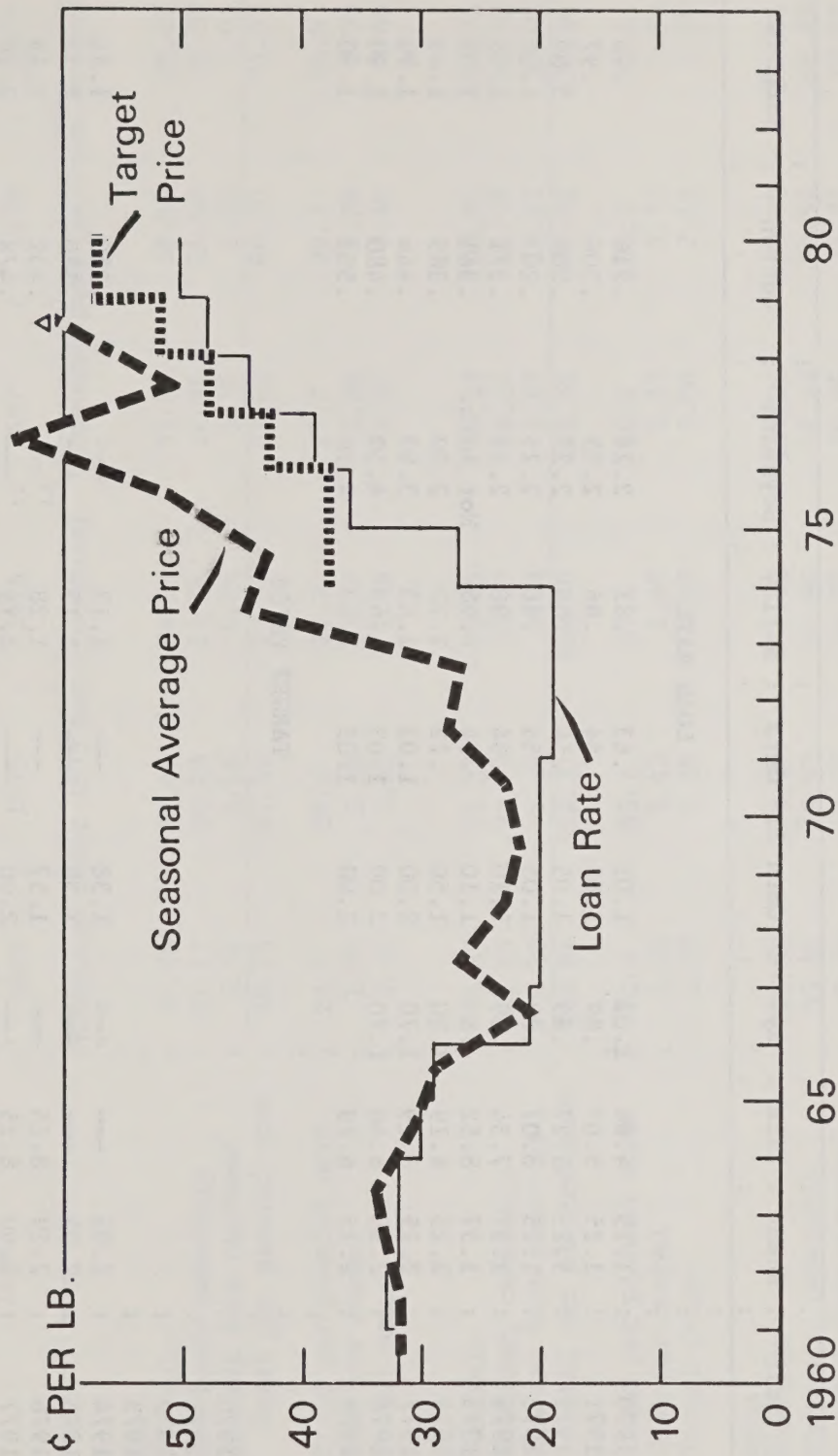


FIGURE 3

COTTON SUPPORT LEVELS AND FARM PRICES



△ Average, August - December

Comparison of Target Prices for Wheat, Corn and Cotton
(on a cost-per-bushel basis)

Item	Crop years						
	1974	1975	1976	1977	1978	1979	
: (Computed under 1973 Act Procedure) (Computed under 1977 Act Procedure)							
<u>Wheat</u>							
Variable	31.55	39.50	39.59	37.51	38.55	39.69	
Machinery ownership	11.17	16.83	17.58	18.96	21.80	25.30	
General farm overhead	5.52	5.18	5.78	6.16	6.55	7.04	
Total per planted acre	48.24	61.51	62.95	62.63	66.90	72.03	
Yield per planted acre	24.7	28.5	27.1	27.7	29.3	28.8	
Cost per bushel	1.95	2.16	2.32	2.26	2.28	2.50	
Target price	2.05	2.05	2.29	2.90	3.40	3.40	
<u>Corn</u>							
Variable	75.43	91.21	93.49	95.83	100.10	102.72	
Machinery ownership	20.99	22.77	26.17	28.16	31.54	36.32	
General farm overhead	8.12	8.39	9.04	9.57	10.02	11.02	
Total per planted acre	104.54	122.37	128.70	133.56	141.66	150.06	
Yield per planted acre	70.4	85.7	87.1	90.9	100.3	92.1	
Cost per bushel	1.48	1.43	1.48	1.47	1.41	1.63	
Target price	1.38	1.38	1.57	2.00	2.10	2.20	
<u>Cotton</u>							
Variable	131.88	143.99	156.22	168.21	163.30	172.65	
Machinery ownership	33.64	46.92	53.96	58.24	60.52	68.69	
General farm overhead	9.70	9.52	10.28	10.95	11.73	12.62	
Total per planted acre	175.22	200.43	220.46	237.40	235.55	253.96	
Less: Value of seed	38.82	34.28	27.54	21.29	27.29	45.10	
Adjusted total	136.40	166.15	192.92	216.11	208.26	208.86	
Yield per planted acre	405	416	436	505	390	451	
Cost per pound of lint	.337	.399	.442	.428	.534	.463	
Target price	.38	.38	.432	.478	.520	.577	(.566)

When the Food and Agriculture Act was enacted in 1977, the target price system was modified. The Congress set the target price 1978 crop wheat at either \$3.00 or \$3.05, depending on that year's production level. The corn target price was set at \$2.10 per bushel. These levels were based on costs of production--variable, machinery ownership and general farm overhead costs--and included a return to management and a 3 to 4 percent return on the current price of land.

The Food and Agriculture Act of 1977 also revised 1973 provisions for wheat, feed grains and cotton, by specifying that annual adjustments of target prices be based on individual commodity production costs rather than on the production cost index. The adjustments were to begin for the 1978 cotton and rice crops and the 1979 wheat and feed grain crops.

The language describing that procedure states:

The established price shall be the established price for the previous year's crop adjusted to reflect any changes in (i) the average adjusted cost of production for the two crop years immediately preceding the year for which the determination is made from (ii) the average adjusted cost of production for the two crop years immediately preceding the year previous to the one for which the determination is made. The adjusted cost of production for each of such years shall be determined by the Secretary on the basis of such information as the Secretary finds necessary and appropriate for the purpose and shall be limited to (i) variable costs, (ii) machinery ownership costs and (iii) general farm overhead costs, allocated to the crops involved on the basis of the proportion of the value of the total production derived from each crop: Provided, that in no event (for cotton) shall the established prices for the 1978 crop be less than 52 cents per pound and for each subsequent crop be less than 51 cents a pound.

The payment rate for grain sorghum and, if designated by the Secretary, oats and barley, shall be such rate as the Secretary determines fair and reasonable in relation to the rate at which payments are made available for corn (PL 95-113).

More simply, the Act says that the target price for a given year is to be the target price for the previous year adjusted to reflect the difference in the average costs of the previous two years from the average

costs for the two years immediately preceding last year. This can be more clearly understood by expressing the procedure as a formula, illustrated below, using 1979 as an example.

$$\frac{\text{1979 target price}}{\text{1978 target price}} = \text{plus or minus} \frac{\text{average of costs in 1977 and 1978}}{\text{average of costs in 1976 and 1977}}$$

This method of setting and adjusting target prices overcame some of the deficiencies in the procedure set down in 1973. Labor, management and land costs were taken into account without building in an inflationary spiral. The same components of costs are covered for all commodities and they remain relevant to the actual crop being produced. Furthermore, because a comparable level of income support is used, producers of the major crops are treated equitably.

There was additional consideration relevant to the determination of the target prices for feed grains other than corn. The Senate-House conferees elaborated upon the language in the bill for these commodities. The Conference Report states:

The conferees consider that if target prices for the other feed grains are established using the same components of the cost of production (as for corn), such target prices would be fair and reasonable in relation to the rate at which payments are made available for corn. (Food and Agriculture Act of 1977, Report No. 95-418)

Thus, meeting the intent of the Congress and as confirmed by a letter from Secretary Bergland to House Agriculture Committee Chairman Foley, we use the same formula for adjusting the target price for grain sorghum as is used for corn.

The Congress, in 1978, increased the Secretary's flexibilities for determining target prices when it passed the Wheat, Feed Grains and Upland Cotton Emergency Assistance Act. That act is also relevant to today's discussion through the following provision:

Notwithstanding any other provision of law, whenever a set-aside is in effect for one or more of the 1978 through 1981 crops of wheat, feed grains and upland cotton, the Secretary may increase the established price for any such commodity by the amount the Secretary determines appropriate to compensate producers for participation in such set-aside (PL 95-279).

The Derivation of 1979 Crop Target Prices

Mr. Chairman, I have a series of tables showing detailed calculations of the 1979 target prices which I will submit for the record. However, at this time, I would like to briefly summarize these calculations for the specific commodities.

Wheat

As I mentioned earlier, the 1978 target price for wheat was set at \$3.00 or \$3.05 in the 1977 Food and Agriculture Act.

The cost of production components specified in the law to be considered for 1979 and later years--variable, machinery ownership, and general farm overhead costs--for wheat averaged \$2.29 for the 1976 and 1977 crop years. These costs averaged \$2.27 for 1977 and 1978. The difference (\$2.27 - \$2.29) is thus a decrease in the average cost per bushel of 2 cents. This difference would have been subtracted from the \$3.00 per bushel target price specified in the 1977 Act, to give a target price for 1979 of \$2.98 per bushel. However, the Secretary made use of the authority granted by the 1978 Emergency Assistance Act.

A 20-percent set-aside was in effect for the 1978 wheat crop. To compensate producers who chose to voluntarily participate in the wheat program, the target price was increased. The increase determined to be appropriate was 20 cents for each 10-percent set-aside. This adjustment resulted in the announced 1979 wheat target price of \$3.40.

Corn

The average of the variable, machinery ownership and general farm overhead costs for corn was \$1.48 for the 1976 and 1977 crops, and \$1.44 for the 1977 and 1978 crop years. The difference (\$1.44 - \$1.48) is a decrease of 4 cents a bushel. Subtracting this amount from the 1978 target price set by Congress at \$2.10, gives a target price of \$2.06 per bushel for the 1979 corn crop.

However, a voluntary set-aside of 10 percent was in effect for 1978. The Secretary--again using the 1978 Act authority to compensate producers setting acreage aside--increased the target price 14 cents to reach the \$2.20 per bushel level announced for the 1979 crop. The diversion payment, however, was decreased from \$0.20 per bushel to \$0.10 per bushel, so the total support remained at \$2.30 per bushel, identical to the 1978 level.

Sorghum

The 1978 target price for sorghum was set \$2.28 per bushel, and the diversion payment at \$0.12 per bushel for a total support of \$2.40 per bushel. The target price was determined using the same components of cost of production as for corn.

The production costs of variable, machinery ownership and general farm overhead for sorghum averaged \$1.76 per bushel for the 1976 and 1977 crops--to be fair and reasonable in relation to corn. They averaged \$1.82 per bushel for the 1977 and 1978 crop years, resulting in an increase of 6 cents per bushel (\$1.82 - \$1.76). The six-cent increase was added to the 1978 target price of \$2.28 to arrive at the target price of \$2.34 a bushel for 1979.

When the 1979 target price for sorghum was originally computed, a \$2.30 target and a \$0.10 diversion payment was announced, keeping the

total level of support at \$2.40 per bushel, the same as the previous years. After examining the cost estimates and calculations leading to the target price adjustment, \$2.34 was determined to be the correct number. On June 29, we announced the sorghum target price was being increased an additional 4 cents a bushel.

Barley

The 1978 target price for barley was \$2.25 per bushel. The average of the 1976 and 1977 variable, machinery ownership and general farm overhead production for barley was \$1.66 a bushel. For the 1977 and 1978 crop years, these components averaged \$1.63, resulting in a decrease of 3 cents a bushel ($\$1.66 - \1.63). Subtracting this 3 cents from the 1978 target price of \$2.25 gives a target price of \$2.22 for the 1979 crop.

A set-aside equal to 20 percent of a producer's planted acreage was in effect for the 1979 crop year. To compensate producers voluntarily participating in this program, the target price was raised to \$2.40 a bushel for the 1979 crop.

Rice

The 1978 target price for rice was \$8.53 per hundredweight.

Variable, machinery ownership and general farm overhead production costs averaged \$6.81 for the 1977 and 1978 crop years. These same costs averaged \$6.29 for the 1976 and 1977 rice crops. This resulted in an increase of 52 cents per hundredweight ($\$6.81 - \6.29). Adding this amount to the 1978 rice target price of \$8.53 per hundredweight resulted in a 1979 target price of \$9.05 per hundredweight.

Cotton

The preliminary upland cotton target price was announced last December 26 at a level of 57.7 cent per pound based on the December 1,

1978 yield estimate and preliminary estimates of production costs. At that time, however, we stated that "...the final target price for the 1979 upland cotton crop will be announced later when final yield and cost estimates become available."

Based on the preliminary estimates, the variable, machinery ownership and general farm costs (adjusted to exclude three-fourths of the value of cottonseed) for upland cotton averaged 43.9 cents per pound for the 1976 and 1977 crop years. These costs averaged 49.6 cents for 1977 and 1978 crop years. The difference would thus indicate an increase in average costs per pound of 5.7 cents. Added to the 1978 target price of 52 cents, this gave a preliminary target price of 57.7 cents per pound for the 1979 crop year.

We are presently in the final stages of determining the final target price for the 1979 upland cotton crop.

1980 Target Prices

Mr. Chairman, having discussed the history, authorities and derivation of target prices since their inception, with particular attention to the 1979 target price levels, I will take this discussion one step further--into the factors affecting the determination of 1980 target prices.

The same authorities governing the establishment of 1979 target prices are currently in effect for the 1980 crops. Program provisions for the 1980 crops are now under consideration.

It is uncertain whether we will have set-asides or not. That will largely depend upon domestic and world crop conditions over the next few weeks. If there are set-asides, then the 1978 Act authorities are available and the formula-calculated target prices would be increased to compensate

for the set-asides. If there are no set-asides, the 1980 target prices will depend entirely on the changes in costs and yields.

Per acre costs are, no doubt, increasing as prices of most major inputs--fuel, chemicals, labor, fertilizer--are increasing. However, target prices are based on unit costs--the planted acre costs divided by yields.

At this time, 1979 crop yields are still undetermined. High yields mean lower unit costs than do low yields. But, per acre costs are also somewhat lower with low yields since lower harvesting and hauling costs are incurred.

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